FINAL REPORT

Volume I

Pacific Gas and Electric Company

Audit of Affiliate Rules Compliance for 2003

As Required By the

CPUC's Uniform Affiliate Transaction Rules

Per CPUC Decisions D.97-12-088, D.98-08-035,

and D.98-11-027

April 28, 2004

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Volume I

Vantage Consulting, Inc.

Pacific Gas and Electric Company
Audit of Affiliate Rules Compliance for 2003

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I. EXECUTIVE SUMMARY

RECOMMENDATIONS VS FINDINGS

A. AUDIT OBJECTIVE AND METHODOLOGY

On December 16, 1997, the California Public Utilities Commission (CPUC or Commission) adopted the Affiliate Transaction Rules ("Rules") in D.97-12-088. These Rules apply to all business transactions between utilities in the State of California and their affiliates, that meet certain criteria. According to *Rule VI.C.*, "No later than December 31, 1998, and every year thereafter, the Utility shall have audits performed by independent auditors who cover the calendar year which ends on December 31, 1998, that verify that the utility is in compliance with the Rules set forth herein. The utilities shall file the independent auditor's report with the Commission's Energy Division beginning no later than May 1, 1999, and serve it on all parties to this proceeding. The audits shall be at shareholder expense." This report addresses the calendar year 2003 and is to be filed by Pacific Gas and Electric Company (Company or PG&E) no later than May 1, 2004.

B. AUDIT APPROACH AND WORK PLAN

Vantage Consulting, Inc., (Vantage) responded to a Request for Proposal prepared by the Pacific Gas and Electric Company Affiliate Rules and Regulatory Compliance Department (ARRC) in October 2001 for the audit of 2001, with an option for two additional years. The 2001 and 2002 audits were completed on time and PG&E subsequently requested that Vantage conduct the 2003 audit as well.

Information gathering and analysis began in November 2003. Field interviews were initiated in December 2003. In total, 237 separate information requests were submitted and utilized in the audit of PG&E. In addition, 37 formal interviews were conducted, with approximately 39 people attending. All members of ARRC were interviewed several times. In addition, several phone calls and e-mails supplemented the interviews.

Sampling and testing of data and transactions were conducted in accordance with appropriate Generally Accepted Auditing Standards (GAAS). In all cases, where required, an adequate sample population was selected for audit testing and conclusions were based on the results of the tested sample. In cases where anomalies were discovered, these items were immediately brought to the attention of Company personnel for immediate correction. A discussion of our use of Generally Accepted Auditing Standards (GAAS) is provided in *Section A of Volume II*.

The final report was completed on April 28, 2004.

C. REPORT LAYOUT

The layout of this report has been designed to accommodate both the senior level reader who has interest in overall conclusions and specific recommendations, as well as the ARRC and CPUC staff who must deal with the specifics of each conclusion and recommendation. To achieve this, we have organized the report into two Volumes. *Volume I* provides an overall summary of our audit as well as details on all areas where problems, if any, were discovered, or where opportunities for improvement exist. *Volume I* is organized into four chapters.

- Chapter I - Executive Summary - provides a summary of our approach, overall conclusions, major findings, and recommendations.
- Chapter II - Background and Issues - provides some perspective on the many major events that occurred in 2003, or were on-going, that had a direct and profound impact on Pacific Gas and Electric Company. It also provides discussion on other major topics such as Federal Sentencing Guidelines and Pacific Gas and Electric Company's bankruptcy.
- Chapter III - Audit Summary - is a table that identifies each section of the Rules that Pacific Gas and Electric Company must comply with, and indicates whether the Company has met the standard. It also has a listing of the analysis our consultants performed.
- Chapter IV – Detailed Audit Analysis - provides details on all areas where problems may exist or where improvements need to be made. It also includes a table that lists last year's recommendations, and summarizes the progress made on implementation.

The details and background used in developing our conclusions have not been discarded. Vantage moved all details on audit process, analysis, and issues with no negative findings into *Volume II*. This Volume will contain a great deal of detail, some of which may be confidential. This detail will include:

- A summary of the GAAS (generally accepted audit standards) used for sampling and analysis.
- A copy of the Work Breakdown Structure (WBS) which provides the outline for work requirements, assignments, and related interviews and information requests.
- An Interview Request List which identifies all personnel interviewed as part of the assignment.
- An Information Request List which provides a description of all information requested from ARRC.
- Work papers which include individual analyses and working notes of each consultant.
- Key data and analysis which includes copies and/or summaries of key data we analyzed or developed.

D. OVERALL CONCLUSION

Before addressing overall conclusions, recommendations and areas that need improvement, let us put the compliance program in perspective.

Pacific Gas and Electric Company has a mature Compliance Plan in place that has evolved over six years, and is generally successful in all areas. The table in *Chapter III* that describes our audit effort and Pacific Gas and Electric Company's compliance with the Rules has 28 individual categories of rules identified. Our analysis indicates that Pacific Gas and Electric Company is in compliance in all areas. This is not to say that there are no recommendations for improvement or that all areas are perfect. In fact, one global and three technical recommendations are made that should lead to continued improvements in both the Affiliate Rules and Regulatory Compliance Program and PG&E's recordkeeping in general.

During 2003, Pacific Gas and Electric Company and the ARRC Department have continued to improve the overall Compliance Plan, especially the implementation of past report recommendations and follow-up. This included a Compliance & Ethics Benchmarking Survey that identified practices of other utilities and industries.

Audit year 2003 continued to be one of turmoil for Pacific Gas and Electric Company and all of California. The on-going bankruptcy filing has put tremendous stress on Pacific Gas and Electric Company, its parent, affiliates, and all employees. The bankruptcy of National Energy and Gas Transmission, Inc. (NEGT, formerly known as PG&E National Energy Group) also played a major role in affiliate compliance. Many of the interactions where Affiliate Rules came into play were relative to NEGT. With this company about to be divested, there are very few instances where Affiliate Rules issues arise. Nonetheless, PG&E continues to comply with the Affiliate Rules, and the compliance program is still in place.

A total of four recommendations have been made in the report. They are summarized below and the details and support related to them are at the end of this volume.

One major point that should not be overlooked is that there were no formal reports of potential violations in 2003.

E. RECOMMENDATION SUMMARY

The following are the recommendation statements from the report. Each recommendation is numbered and references the findings that support it. Details on each recommendation are in Section IV.

R1 The current compliance program for Affiliate Rules, including training, reporting, and record-keeping, should be continued even though the likelihood of affiliate transactions has diminished with the pending exit of NEGT and other related companies. (This is a general recommendation and not specific to any findings.)

R2 Re-evaluate the DTR/SAP Reconciliation to determine how the process could be improved and possibly streamlined. (Refer to Finding F8 (Volume II))

R3 Assign ownership of employee departure notification and the Departing Employee Checklist (DEC) to a specific department, such as Human Resources or Payroll to ensure that the checklists are complete and more importantly, that the tasks that need to be completed (notifying Payroll and Information Technology of employee departure) have occurred. (Refer to Finding F12 (Volume II))

R4 Appoint a study committee to begin the design and implementation of a new work order entry system. (Refer to Finding F16 (Volume II))

II. BACKGROUND AND ISSUES

This Chapter has two objectives. First, we provide discussion and detail on some key elements of the audit. Second, we discuss the issues relevant to this engagement. The key elements include:

A. Federal Sentencing Guidelines
B. Violation Reporting Mechanisms
C. Affiliate Rules Modifications
D. Bankruptcy and Plan of Reorganization
E. Utility Electricity Procurement
F. Compliance & Ethics Benchmarking Survey Results

A. FEDERAL SENTENCING GUIDELINES

Federal Sentencing Guidelines are the underpinnings for the compliance at Pacific Gas and Electric Company to all rules and regulations. To understand the systems set in place, it is helpful to have a basic understanding of the Federal Sentencing Guidelines. The excerpt below is from *An Overview of the Organizational Guidelines*, by Paula Desio, Deputy General Counsel, United States Sentencing Commission.

The Federal Sentencing Guidelines were put in place in response to the disparity in sentencing made by judges in the legal system. A Commission was established to create polices and practices for sentencing, advising Congress and the Executive Branch on crime policy, and to serve as an information source in this area.

Organizations, like individuals, can be found guilty of committing crimes. Individuals within organizations can commit crimes that the organization can be found guilty of despite its best efforts to maintain a crime-free workplace. The federal sentencing guidelines for organizations were put in place to establish criteria for programs that organizations can run to help lessen the risk of crimes being committed within the organization. If an organization has a program in place that follows the established criteria, its potential fine range can be lessened by as much as 95%. This mitigation is also contingent on quick reporting of the incident and the lack of involvement in the incident of those highest in the organization.

Seven key criteria are outlined in Chapter Eight of the Federal Sentencing Guidelines that are required to be in place for a Company program to be acceptable. These are:

1. *Compliance standards and procedures reasonably capable of reducing the prospect of criminal activity*
2. *Oversight by high-level personnel*
3. *Due care in delegating substantial discretionary authority*
4. *Effective communication to all levels of employees*
5. *Reasonable steps to achieve compliance which include systems for monitoring, auditing, and reporting suspected wrongdoing without fear of reprisal*

6. *Consistent enforcement of compliance standards including disciplinary mechanisms*
7. *Reasonable steps to respond to and prevent further similar offenses upon detection* of a *violation.*

These criteria are purposely vague to encourage companies to put in place a system that works for them and is tailored to their needs and organization. Pacific Gas and Electric Company has developed a compliance program that meets these criteria.

B. VIOLATION REPORTING MECHANISMS

HELPLINE

The Legal Compliance and Business Ethics (LC&BE) Helpline is used throughout the organization of PG&E Corporation companies for reporting of perceived violations or to obtain guidance on various issues. The telephone number is advertised in various handbooks and tri-folds given to employees and also on posters scattered throughout the companies. It is maintained at the Corporation and used by Corporation, Utility, and Affiliate company personnel.

The ARRC department maintains a similar service for Utility employees on Affiliate Rules issues and refers to it as the Policy and Advice Helpline. The ARRC Helpline phone number is advertised alongside the LC&BE number in the Affiliate Rules booklet. The ARRC department also maintains an e-mail box to receive similar information. The questions are handled by the most appropriate ARRC person with the experience in that area.

If there is any question as to how to respond for issues from the two helplines, the ARRC and LC&BE staff will meet and discuss. Whoever has been designated as the most appropriate person to respond to this issue, will write it up for inclusion in the Policy and Advice Log maintained in the ARRC department or in the LC&BE database.

Calls to the LC&BE Helpline regarding Affiliate Rules in 2003 have declined from 2002 and previous years. This decline shows the decrease in interactions between the Utility and Rule II.B. Affiliates now that NEGT will soon be divested. This reverses the slight increase from 2001 to 2002 which represented the teams of people meeting across the PG&E Corporation companies to discuss bankruptcy related Plan of Reorganization (POR) issues. Also, PG&E National Energy Group (NEGT) saw an increase in those taking the Affiliate Rules Computer Based Training (CBT) courses. These employees may have had follow-up questions to their training based on real circumstances in which they found themselves. The trend for the ARRC Policy and Advice (P&A) helpline and the LC&BE helpline is similar. Calls in 2003 returned to the same levels as 2001 with 2002 showing a slight increase. The early years, 1999 and 2000, of the Affiliate Rules show calls significantly higher than 2001. This trend follows the same trend as that for the LC&BE Helpline.

	1999	*2000*	*2001*	*2002*	*2003*
LC&BE Helpline calls	82	93*	37	55	31
ARRC calls/ P&A	165	110	30	42	22

* 13 month period 11/1/99 – 11/30/00 does not materially affect the trending analysis

C. AFFILIATE RULES MODIFICATIONS

During 2000, the CPUC established a forum to receive comments on its affiliate transaction rules from all interested parties. The intent was to re-visit the rules after they had been in effect for three years, to determine if there was a need to modify the rules. Numerous comments were received. Generally, the comments suggested modifications that would simplify, and further clarify, the rules. In addition, there were suggestions for modifications to reduce the cost of compliance with the rules. Based on these comments, and consistent with the intent of its original orders on these matters, the CPUC initiated OIR 01-01-001 on January 4, 2001. This rulemaking intended to "re-look" at the affiliate transactions rules, as well as interim reporting requirements. In this order, the CPUC reiterated its objectives. The primary objectives were to foster competition and protect consumer interests. In addition, the CPUC stated that it wanted to prevent cross-subsidization and self-dealing, customer confusion in product promotion and advertising, and to protect the Utility's release of customer-specific information. The order included a procedural schedule that anticipated a final order by October 2001. On April 25, 2001, the CPUC issued an order that stayed any further proceedings in OIR 01-01-001.

On April 3, 2001, the CPUC issued an Order Instituting Investigation, OII 01-04-002. The order indicated the CPUC's interest in investigating whether the utilities and their respective holding companies, violated relevant statutes, CPUC rules and decisions. The CPUC also expressed its interest in determining whether changes should be made to rules, orders, and conditions pertaining to respective holding company systems.

Both of the aforementioned proceedings, OIR 01-01-001 and OII 01-04-002, raise issues that could potentially have a direct impact on the CPUC's rules governing affiliate transactions and related reporting requirements. However, during 2002 and 2003 no action was taken in these dockets. Thus, at this time, there is no impact on PG&E's Compliance Plan or this audit.

D. BANKRUPTCY AND PLAN OF REORGANIZATION

On April 6, 2001, PG&E filed bankruptcy pursuant to Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court for the Northern District of California. The key factor in leading PG&E into bankruptcy was the dramatic increase in wholesale energy prices during the summer of 2000. There was no regulatory mechanism for PG&E to recover the increased costs so PG&E applied to the CPUC for an emergency rate increase.

When the emergency rate relief was not forthcoming, PG&E was forced to file for bankruptcy protection.

On September 20, 2001, PG&E filed a Proposed Plan of Reorganization ("POR"). Under the POR, four lines of business would be established. The lines of business would be retail gas and electric distribution; electric transmission; interstate gas transmission; and electric generation. Further, the proposed POR provides that a separate holding company would be created and that the electric transmission, interstate gas transmission, and electric generation lines of business would become wholly owned subsidiaries of PG&E Corporation. PG&E (the Utility) would retain the retail gas and electric distribution function, and become a stand-alone gas and electric distribution Utility regulated by the CPUC.

In April 2002, the CPUC proposed an alternative plan of reorganization. The Official Committee of Unsecured Creditors joined in its support for the CPUC alternative plan. On December 19, 2003, the CPUC, PG&E Corporation and PG&E entered a settlement agreement that resulted in a new POR. Under the new POR, PG&E remains a vertically integrated Utility. On December 22, 2003, the bankruptcy court confirmed the new POR. Although there have been requests for rehearing at the CPUC and appeals filed with the U.S. District Court, the bankruptcy court has ruled that the implementation of the POR should proceed. The implementation of the POR is subject to various conditions before it becomes effective. These conditions include the consummation of a public debt offering to pay allowed creditor claims in full, the receipt of investment grade credit ratings and final CPUC approval. At the time of preparing this report, PG&E had emerged from bankruptcy on April 12, 2004.

Although the bankruptcy has been a tremendous distraction for management, it has no immediate impact on PG&E's current Affiliate Rules Compliance Plan, or our audit of PG&E's Compliance Plan for 2003.

E. UTILITY ELECTRICITY PROCUREMENT

Beginning January 1, 2003, PG&E resumed responsibility for procuring electricity for its residual net open position. In January 2004, the CPUC adopted an interim decision that requires the California investor-owned electric utilities to achieve, by January 2008, a reserve margin of 15-17% in excess of peak requirements, as well as to have established a diverse portfolio of electricity sources. The interim decision continues a permanent ban on affiliate transactions for procurement, but for three exceptions. One of those exceptions, on page 25 of the CPUC Decision D.04-01-050, relates to PG&E. The exception is for "(T)ransactions for natural gas services between SDG&E and SoCalGas, and between PG&E and affiliates, and operating divisions that are found necessary and beneficial for ratepayer interests." These transactions will be subject to rules adopted by CPUC and these transactions will be the subject of a management audit review. The CPUC notes that dealings with PG&E affiliates that provide gas storage and intrastate backbone gas transmission services, may be necessary for PG&E to perform its electricity procurement function efficiently. In the event that these exceptions come into play, the CPUC has established rules to provide assurance that the ratepayers' interests are protected. PG&E's

compliance with these rules will be subject to independent audit. It appears that the exceptions that the CPUC has established in its utility electricity procurement decision, may have an impact on PG&E's Compliance Plan in the future, depending on PG&E's actual operations in managing its procurement function. However, there was no impact on this audit of the 2003 Compliance Plan.

F. COMPLIANCE & ETHICS BENCHMARKING SURVEY RESULTS

The ARRC Department contracted with an outside company, Tucker Alan, Inc., to perform a "Compliance & Ethics Benchmarking Survey." A total of 261 companies were contacted, 83 responded, of which 50% were regulated utilities and 31 were electric or gas utilities. This survey is valuable for a number of reasons. First, it demonstrates the intent of the ARRC Department to measure itself against other companies. Second, it provides some insights for improvements in policies at PG&E. Some of the interesting results worth summarizing include:

- 94% of companies surveyed use in-house compliance departments, including PG&E.
- 94% of all companies surveyed, including PG&E, have an in-house compliance and ethics officer.
- PG&E uses nine means of internal communications to disseminate information about its programs.
- 89% of the surveyed companies follow Federal Sentencing Guidelines.
- PG&E required one hour per year of compliance and ethics training which agrees with 32% of the respondents. 32% said they require more than one and one-half hours per year and 23% said they require none.
- 88% of new employees get training. 40%, including PG&E, get it within first month.
- Only 30% of companies indicate their Board of Directors is involved in the Compliance and Ethics Committee. PG&E is one of these companies
- All levels of management at PG&E must attend training.
- 90% of all surveyed companies use a departing employee checklist to assure closure and return of company assets, confidential information, security issues, etc. 72% do not withhold the final paycheck until the checklist is complete, 26% do withhold the final paycheck. PG&E requires completion of a departing employee checklist, but does not hold final paycheck pending completion.

III. AUDIT SUMMARY

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section II. Applicability & Training	**Yes**	None	• Reviewed Attachment D listing of companies • Isolated inconsistencies with the list and other sources, including Compliance Plan, Attachments A – K, excluding D, reviewed Web Site, specifically looking at linked and related companies. • Reviewed changes from previous years and determined appropriateness
Reference Section III. A. No Preferential Treatment	**Yes**	None	• Call monitoring system audit • Customer Service Representative training review • Reviewed information provided to employees including new hire orientation handout.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section III.B. Offering of Discounts	**Yes**	None	• Reviewed all relevant sections of Attachment B Affiliate Rules Memos and the Detailed Summary of Affiliate Rules Compliance Plan • Reviewed DTRs and all supporting documentation on a sample basis. • Reviewed details of all transactions between Core Gas Procurement, CGT and affiliates, and cross-checked to DTRs, external postings, transaction records and supporting documentation.
Reference Section III.C. Tying of Services Prohibited	**Yes**	None	• Reviewed all training presentations • Reviewed number of employees trained compared to previous years • Reviewed internal and external information channels to verify no tying.
Reference Section III.D. No Assignment of Customers	**Yes**	None	• Verified that PG&E does not assign customers to affiliates.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section III.E. Business Development and Customer Relations	**Yes**	None	• Reviewed Compliance Plan for current requirements • Interviewed key ARRC and management personnel • Analyzed complaints and/or transactions in this area.
Reference Section III.F. Affiliate Discount Reports	**Yes**	None	• Reviewed DTRs and all supporting documentation on a sample basis • Reviewed details of all transactions between CGP, CGT and affiliates and cross-checked to DTRs, external postings, transaction records and supporting documentation. See also III.B
Reference Section IV.A. Customer Information	**Yes**	None	• Verified by selecting a statistical sample of the Customer Information Release Request (CIRR) database that customer authorizations are obtained before releasing customer information. • Verified through interviews, information requests, and observation that adequate policies are established and disseminated regarding release of customer information. • Verified through interviews, information requests, and observation that customer information releases are posted on the Internet site. • Verified through information requests and observation that the departing employee checklist appropriately addresses Standards for Personal Conduct and Business Decisions

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section IV.B. Non-Customer Specific Non-Public Information	**Yes**	None	• Reviewed training information (intranet based) • Reviewed the policies and procedures pertaining to IV.B. • Reviewed D.98-08-035, modifying D.97-04-011
Reference Section IV. C. Service Provider Information	**Yes**	None	• Reviewed lists of information provided to CPUC for dissemination to ratepayers
Reference Section IV.D. Supplier Information	**Yes**	None	• Discussed with Procurement personnel to determine that no non-public information and data was provided to any third parties
Reference Section IV.E. Affiliate Related Advice or Assistance	**Yes**	None	• Verified by obtaining objective, verifiable evidence that the policies for communicating with customers regarding bundled service, virtual direct access, etc. are in place and have been communicated to new employees who may need to address this issue.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section IV.F. Record Keeping	**Yes**	Improvement compared to 2002	• Reviewed DTR database, additionally reviewed 30 randomly selected DTRs, reviewed DTR/SAP reconciliation work papers, interviewed ARRC department personnel. • Reviewed detailed purchasing practices of Gas Procurement Dept. relative to affiliates including: - DTR Summary Log - Weekly Reminders - Affiliate Reminders - Affiliate Binder
Reference Section IV.G. Maintenance of Affiliate Contracts and Related Bids	**Yes**	None	• Verified by obtaining objective, verifiable evidence that contract and bid records are maintained for a minimum of three years. • Reviewed all contracts with Rule II.B Affiliates for 2003.
Reference Section IV. H. FERC Reporting Requirements	**Yes**	None	• No analysis performed in this area

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.A. Corporate Entities	**Yes**	None	• Reviewed Holding Company Decision and Application (D.96-11-07 and A.95-10-024) • Reviewed Prior Year audit report • Reviewed financial information, noting separation, available on the internet • Discussed with ARRC and Corporate Accounting personnel
Reference Section V.B. Books and Records	**Yes**	None	• Reviewed Financial Statements • Reviewed Prior Year Audit report • Discussed with ARRC, Internal Auditing and Corporate Accounting.
Reference Section V.C. Sharing of plant, facilities, equipment, or costs	**Yes**	None	• Performed walk-through of the Company noting access is controlled • Reviewed that no instances in which affiliates share space with the Utility exists • Noted SAP controlled access
Reference Section V. D. Joint Purchases	**Yes**	None	• Interviewed Procurement personnel. Reviewed cost allocations of jointly purchased software licensing. No other items were jointly purchased.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.E. Corporate Support	**Yes**	None	• Reviewed services allowed as noted in the Compliance Plan and Attachment E • Reviewed all Inter Company bills noting services provided and received and trending of dollars • Reviewed services not allowed and reviewed Inter Company bills for those • Confirmed through interviews that services not allowed are not provided • Through all work noted no instances in which support services was being used as a conduit to pass information • Examined allocation methods used by PG&E Corporation • Reviewed confidentiality agreements signed by Corporate Communications and Public Relations • Reviewed memos distributed regarding Corporate Support and Affiliate Rules • Discussed with other team members their review results • Interviewed ARRC, Corporate Accounting, Gas Procurement, Legal, and Technological and Ecological Services (TES) Personnel

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.F. Corporate identification and advertising	**Yes**	None	• Reviewed website noting appropriate identification • Reviewed training • Reviewed Corporate Booklets and internal checklists • Reviewed inter-company checklists • Reviewed R&D work and advanced technology research • Interviewed ARRC, LC&BE personnel

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.G. Employees	**Yes, but noted weakness within PG&E for Departing Employee Checklist (DEC) collection**	1) System not in place for DEC's to be completed timely at Utility. There were no transfers to Affiliates so this is not an Affiliate Rules issue.	• Analyzed transfer fee noting appropriateness • Interviewed transferred personnel • Reviewed officer and directors listing noting appropriateness • Reviewed DEC's noting compliance • Reviewed rotating employees and agreements • Reviewed signed confidentiality agreements for sample of new employees
Reference Section V.H. Transfer of goods and services	**Yes**	None	• Verified by obtaining objective, verifiable evidence that transfers of goods and services between the Utility and its Rule II.B affiliates are priced as required by the Rules. • Verified by obtaining objective, verifiable evidence that procedures are in place for transfer and billing of goods and services transferred between the Utility and its Rule II.B Affiliates. • Verified by obtaining objective, verifiable evidence that procedures are in place to assure that the Rules regarding accounting are being adequately enforced

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section VI.A. Regulatory Oversights	**Yes**	None	• Reviewed Compliance Plan in conjunction with CPUC regulations
Reference Section VI.B. New Affiliate Compliance Plans	**Yes**	None	• Reviewed last two Compliance Plans • Reviewed all advice letters filed with CPUC in 2003 • Interviewed ARRC personnel
Reference Section VI.C. Affiliate Audits	**Yes**	None	• Reviewed ARRC monitoring plan, Reviewed Prior Year audit report • Discussed audit plan with ARRC personnel
Reference Section VI.D. Witness Availability	**Yes**	None	• Interviewed ARRC personnel
Reference Section Non-tariffed Products and Services VII. A-H	**Yes**	None	• Reviewed and analyzed Categories of Non-Tariffed Products and Services from 2002 draft annual report to CPUC. • Reviewed cost allocation methodologies. • Reviewed mechanisms developed for treatment of benefits and revenues. • Summarized and reviewed reports developed for non-tariffed products and services. • Summarized and reviewed property transfers. • Reviewed all advice letters addressing non-tariffed products and services

IV. DETAILED AUDIT ANALYSIS

A. SUMMARY OF 2002 RECOMMENDATION DISPOSITION

The 2002 audit provided three recommendations for consideration by ARRC and PG&E. All three were addressed in a satisfactory manner. The following table illustrates the actions taken on each recommendation.

SUMMARY OF 2002 AUDIT RECOMMENDATIONS

Recommendations	Affiliate Rule	Action Plan	Resolution
R1 - Continue emphasis and correspondence to management regarding need for timely DTR submittal.	Rule IV.F. - Record-Keeping	Per Vantage, "Great strides were made in 2002 regarding the submittal of DTRs. ARRC needs to continue to emphasize this activity." ARRC will continue to inform and remind Utility personnel of this requirement via various communication avenues.	Completed throughout 2003.
R2 - Ensure that signed confidentiality forms are obtained and that the new employees have been informed of their confidentiality responsibilities to the Company.	Rule V.G. - Employees	ARRC to work with HR.	HR employed a person to specifically address this issue. Also, this is being handled during New Employee Orientation
R3 - Update the Compliance Plan to reflect and refer to the Corporate Policy Handbook called "Standards for Personal Conduct and Business Decisions".	Rule II. - Applicability, Rule VI - Regulatory Oversight	To be completed with next filing of Compliance Plan no later than December 2003.	Updated in the December 23, 2003 Compliance Plan Filing.

B. ISSUES IDENTIFIED IN 2003 AUDIT

This section provides our analysis, findings, and recommendations for those areas of affiliate compliance in which improvements could be made. Please note that in cases where there were no issues or negative findings, our analysis is summarized in *Chapter 2* and details on our work are provided in *Volume II.* The reference numbers for finding are from the sequential numbering of all findings in *Volume II.*

The following is the list of areas or rule sections discussed in this chapter.

Rule	Topic	Recommendation Numbers
General	General	R1
IV-F	Record Keeping	R2
V-G	Employees	R3
V-H	Transfer of Goods and Services	R4

GENERAL

R1 <u>The current compliance program for Affiliate Rules, including training, reporting, and record-keeping, should be continued even though the likelihood of affiliate transactions has diminished with the pending exit of NEGT and other related companies.</u> (This is a general recommendation and not specific to any findings.)

This recommendation is based on our overall assessment of PG&E Corporation, PG&E and its affiliates current state relative to affiliate transactions. Some employees have suggested that since there are almost no affiliate transactions or opportunities for affiliate violations with the pending divestiture of NEGT, the level of training and compliance requirements be reduced. We do not believe the rules currently permit this. Further, we would caution that this could be a problem as new subsidiaries are started or acquired, that once again result in the need for strict affiliate compliance.

RULE IV.F. RECORD KEEPING

DTR Reporting

Each quarter, the Accounting and ARRC departments combine efforts and send out a report showing all DTR activity and all SAP activity involving Rule II.B. affiliates by Utility area. If an employee files a DTR there should be a SAP charge to go with it (unless the DTR is marked "not billable"). If there is a SAP charge with a Rule II.B. affiliate, there should be a DTR also (this is always the case). The DTR/SAP reconciliation combines the information on the DTR system in ARRC and the SAP information in Accounting. Reports are created that show DTR and SAP activity compared and these are referred to as the DTR/SAP reconciliation reports.

The DTR/SAP reconciliation process begins with reconciliation reports being attached to memos and sent to VPs and Directors. The memo asks that the reconciliation reports be reviewed for accuracy and completeness. It also states this review is a requirement and non-compliance could result in fines or imposed business limitations. A checklist accompanies the reconciliation to help the recipient look at the SAP/DTR data and reconcile it in a meaningful way. In 2001, the reconciliations were sent to Managers instead of VPs and Directors. ARRC felt the reconciliations were not getting the attention they warranted at the Manager level. It was at this point (2002), that the memos and reports started going to the VPs and Directors and ARRC believes that there is an increase in the timeliness of the response and the attention paid to the reports, which is confirmed by the timeliness of the responses to the DTR reconciliation reports. Overall, ARRC believes 2002 and 2003 was a much smoother process in the receipt of the individual reconciliation reports than 2001. It is still the managers that oversee the reconciliation review, but now they do this at the directive of their VP or Director instead of the ARRC department. Although this appears to be a small change, it has had a positive effect. The process may also be smoother because it has been in place for several years. The personnel that work with the reconciliation report have seen it before and have a feel for what it is that they need to do.

Once the reconciliation report has been reviewed and changed if necessary, the memo is signed and returned to ARRC and Accounting, along with the checklist and the corrected reconciliation report, if applicable. To control this process, a list is maintained by ARRC and Accounting to indicate receipt of the returned form or forms. The memo, checklist, and report are distributed via e-mail to company VPs and Directors.

Our review in this area noted that:

- The reconciliation process has slowed compared to 2002, (see finding and recommendation below)
- Late DTRs continue to decrease from previous years, and
- DTRs themselves continue to be filled out completely and appropriately.

Overall this process is functioning. The following sections detail the work and processes regarding DTRs.

DTR Policy and Procedures

We reviewed the PG&E quarterly SAP/DTR Guidelines for the 2002 Audit. They consist of six items and did not change in 2003. These Guideline points are:

- Mailing will go out 30 days after end of the quarter.
- Work (including collection and follow-up) to be completed 60 days after the end of the quarter.
- Do not call VPs or Managers directly. Try to work with secretaries of VPs and Managers unless they call you first. If unsuccessful with follow-up, please update Affiliate Transactions Accounting Director or Affiliates Rules and Regulatory Compliance Director or Senior Compliance Consultant for follow-up.
- We will pursue all time discrepancies unless, in total for one cost center, the amount is less than .5 hours.

- For follow-up purposes, the alphabet will be split, A-K and L-Z, between Affiliate Transactions Accounting (Accounting Analyst) and Affiliate Rules and Regulatory Compliance (Business Analyst).
- Review of work in Step 5 will mainly be performed by ARRC's Senior Compliance Consultant.

These guidelines are very general and do not describe the process as much as give guidance to a process that is already in place and working.

DTR test to the Database

Vantage reviewed 30 DTRs selected at random. Fifteen were selected from the files and fifteen were selected from the database and then the completed DTR form reviewed. The DTRs were reviewed for DTR number, the date received by review of the date stamp on the DTR, the date of the occurrence, name of the employee filing the DTR, affiliate involved with the occurrence and if the DTR was posted or not, (all non-posted DTRs were determined to be Corporate Support related), and finally, if posted or not posted decision was logical.

This test was not conducted to give a conclusion regarding the DTR database population as a whole. Instead it was intended to give a small, but very detailed review of the DTR documents supporting the database. Of the 30 items, one was found with an input error so that the DTR appeared to be posted as recorded in the database, but in actuality, it was a DTR documenting support and therefore is not a postable event. One item out of thirty is a minor variance and was not used to make a conclusion as to the accuracy of the database. It was discussed with ARRC Supervisor for their review and follow-up.

Reconciliation Review

We reviewed the binders holding the 1st through 3rd quarter information for 2003, (as our review was conducted in mid-early March, we did not review the 4th quarter as it was completed, but not yet reviewed. The ARRC representative that coordinates and reviews the DTR reconciliation process, indicated that the 4th Quarter 2003 binder will be set-up the same way as the first three quarters.) During 2003 fieldwork, we did review the 4th Quarter from 2002 and noted that it was set-up the same way as described by the ARRC representative, and we noted no oddities or discrepancies in the binder. The binders for each quarter are set-up with tabs by VP/Director for each of the affiliate transactions. There are 2 binders for each quarter separated by VP/Directors last name. A through K remains in Accounting and L through Z is maintained in ARRC. We reviewed the binders for completeness and reasonableness and appropriate documentation to the task.

F8 2003 DTR reconciliation data indicates that the Reconciliation process is not as complete or as well organized as it was in 2002.

The 2002 DTR/SAP Reconciliations were completely appropriate, however, the Reconciliations in 2003 were slightly shy of that mark. Review of the first, second, and third quarter DTR reconciliations of 2003, show lead sheets that are not completed in the second and third quarter. The lead sheets list the reconciliation reports and a date received is placed next to reports that have been received in the department. The lead sheets in 2003 binders are missing "dates received" for a small number of DTR/SAP reconciliations. Review of the Reconciliation report prepared by ARRC shows that the reconciliation report had actually been received but the date was not recorded on the lead sheet. Review of the book prepared by Accounting shows that when the lead sheet shows no date received, there is not a report filed appropriately in the book. However, this reconciliation report was later discovered to be in the front pocket of the book with many other unrelated papers. Currently, this Reconciliation sheet and checklist has now been filed appropriately in the book under the appropriate tab, so it can be found easily if it is needed in the future.

The reconciliation books are not as well organized as 2002. The reconciliation book prepared by Accounting has many loose papers inside the front pocket of the book. These should be either filed in the book where they belong or thrown away, if they do not support anything in the reconciliation process.

The DTR/SAP reconciliation goal is to have the DTR/SAP reconciliation form out to departments at 30 days after quarter-end and then to have 80% to 90% of the forms signed, and returned 60 days after quarter-end. In 2003, we noted that only the first quarter was completed and 2nd and 3rd quarter still had a few outstanding items. The reconciliations were substantially complete, but with the 3rd quarter ending 6 months ago, it is reasonable that the reconciliations would be 100% complete. In 2002, the responses from departments were 80%-90% complete at the 60-day mark and were 100% complete within 30 days after that. Our fieldwork in January 2003 confirmed the completion of the 1st through 3rd quarters of 2002 at that time. In 2001, the DTR/SAP reconciliation did not occur timely with the end of 2001 having only one quarter complete and reconciled. The remaining quarters lagged significantly behind with only preparatory work being complete at the end of the year for 2nd through 4th quarters. 2003 is an improvement over 2001, but 2002 was the best year for the DTR/SAP reconciliation process.

R2 Re-evaluate the DTR/SAP Reconciliation to determine how the process could be improved and possibly streamlined. (Refer to Finding F9 (Volume II))

Apparently something has changed within the DTR/SAP Reconciliation process. This task is large and uses the combined efforts of ARRC, Accounting, and many people across the organization that review and approve the reconciliations. Although the difficulty in completing this task is recognized, so is the value. This process brings to light DTRs that otherwise would be not filed, (as the DTR aging analysis was completed (see below) there are several instances of DTRs being filed soon after the reconciliations are received throughout the company.) The entire process needs to be reviewed and efficiencies created, if possible. Otherwise, only with continuing and diligent management will this process be able to stay on track and stay timely.

RULE V.G. EMPLOYEES

Departed Employees

No employees transferred from the Utility to a Rule II.B. affiliate in 2003. Therefore, no Departing Employee Checklists (DECs) were kept and tracked by ARRC. This process was found to be operating well in 2002 and there are no indications that procedures have changed since that time.

In 2003, Vantage reviewed DECs from PG&E, regardless of whether the employee went to a Rule II.B. affiliate or not. Below is what was found.

F12 Departing employee checklists are not being completed consistently as employees leave the company.

In 2002, ARRC closely monitored the DEC process and followed-up on any departures to ensure that DECs were created appropriately and timely. However, as this area was reviewed, it became apparent that without this ARRC intervention it was likely that a DEC would not be created for a departing employee. To verify this, in 2003 Vantage tested 60 departures of PG&E employees company-wide and reviewed the DECs created with each departure. We noted that of the 60 departures, 17 did not have checklists created.

The checklists are used by the supervisors of departing employees to ensure that all the processes that need to take place, are completed. For instance, Payroll needs to be contacted to stop issuing paychecks. IT needs to be contacted to suspend computer access. All keys, pagers, and any other equipment given to an employee during employment needs to be turned in to the supervisor. Without the checklist, it is more than likely that a few things will be forgotten as an employee leaves. In 2001, when employees did leave the Utility for a Rule II.B. Affiliate, the Vantage interviews with these employees indicated many problems occurred with the departure process. One employee received two paychecks. Another employee was able to access the computer system using the log-in from his previous assignment. The checklist is a tool that assists in the process of transitioning an employee to a non-employee status.

This is a very difficult thing to mandate across PG&E because there is no one person, or department that coordinates this effort. Each supervisor is responsible for the employees that leave from their area. The test of DECs indicates that a substantial number of supervisors are not following this requirement. Note that this is for the Company as a whole, not just an ARRC related issue.

R3 Assign ownership of employee departure notification and the Departing Employee Checklist (DEC) to a specific department, such as Human Resources or Payroll, to ensure that the checklists are complete, and more importantly that the tasks that need to be completed (notifying Payroll and Information Technology of employee departure) have occurred. (Refer to Finding F12 (Volume II))

This is a challenge for PG&E as it appears that no one group is consistently receiving notification of a departure. The responsibility for this issue logically resides with Human Resources or Payroll, as many things occur in that area upon the departure of an employee (benefits changed, etc.). This might require a joint effort of HR, IT, Payroll and Security who would regularly inform each other of any departure notifications that they received, then one designated group would follow-up each case, determine that the checklist has been completed and all necessary tasks completed that are required of an employee departure.

Human Resources has successfully taken and resolved the problems with obtaining Non-Disclosure Agreements (NDAs) from new hires. This problem is similar in scope to the departing employee checklists, in that the problem exists company wide and it is the responsibility of the individual supervisors to complete this task.

The Benchmarking survey completed in 2003 gives further information on how other companies handle departing employee issues.

Although DECs are an issue for PG&E as a company, this is not an issue in ARRC. ARRC does follow-up on DECs upon learning of an employee leaving for employment at a Rule II.B. Affiliate.

RULE V.H. – PROCEDURES FOR TRANSFER OF GOODS AND SERVICES

One step in our work plan was to determine whether Work Order approvals (e-mails) are on file. We discovered that PG&E's order entry system is old, and has suffered from the normal riggers of continued maintenance and programming updates. Sometimes, the automated work order approval process does not work. To ensure that all orders receive the proper approvals, approvals are emailed to accounting. These emailed approvals are logged and hard copies are kept on file with the orders.

The log and hard copies of emailed work order approvals were obtained, and reviewed. For selected transactions, the email approvals were traced to the invoices.

No exceptions were noted in the review of procedures for transfer of goods and services.

F16 PG&E's order entry system is old, and has suffered from the normal riggers of continued maintenance and programming updates. Sometimes the automated work order approval process does not work.

The Utility uses a system of emailing work order approvals to Accounting, when the automated system does not work. A new order entry system is needed. With the current state of change in the operating environment with the Utility and its affiliates, it would be difficult to design and implement a work order entry system that would fit the final structure of the Utility and its affiliates. However, the situation should be monitored closely and design of a new order entry system should be initiated at the earliest possible time.

R4 Appoint a study committee to begin the design and implementation of a new work order entry system. (Refer to Finding F17 (Volume II))

This group, headed by Accounting, could monitor the Utility's changing organizational and operating environment, to determine when it is feasible to begin the design and implementation of a new automated work order entry system for the Utility. Work should begin as soon as it is feasible to do so.